12008
Turkey

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Long-term Rating	BBB-
Outlook*	Negative
Short-term Rating	-

*Long-term Rating refers to Foreign Currency Long-term Issuer Rating in principle.

1. Overview

Turkey is a major power in the Middle East with a population of approximately 80 million people, with a land area of 780,000 square kilometers (approximately twice that of Japan) connecting Europe and Asia. Its gross domestic product (GDP) in 2018 totaled USD 773.4 billion, the largest in the Middle East, with per capita GDP reaching USD 9,632. While it is a member of the G20, it has joined the EU Customs Union, and its economic ties with Europe are strong.

Ethnically, Turkish account for about 70% of the population, with Kurds accounting for about 20%. The Middle East is said to have about 20-30 million Kurds, of whom some 15 million live in Turkey. More than 90% of the population is Muslims.

2. Social and political bases

Since the foundation of the Republic of Turkey in 1923, secularism advocating separation of politics and religion has been the country's principle. Its parliament is based on a unicameral system and the pro-Islamic Justice and Development Party (Turkish: Adalet ve Kalkınma Partisi, AKP) has been in power since 2002. The administration is led by AKP leader Recep Tayyip Erdoğan, who served as Prime Minister from 2003 to 2014 and has been President since 2014. The political and social situation in Turkey has worsened significantly in recent years, but is now showing signs of improvement.

On the political front, President Erdoğan's political base has been increasingly strengthened. The presidential and general elections were held in June 2018. The elections had been initially scheduled for November 2019, but President Erdoğan moved them forward to June 2018 as the opposition camp intensified campaigns against his presidency by forming a new party. In the presidential election, incumbent Erdoğan won the first ballot by garnering 52.6% of the votes. The provisions of the Constitution amended after the April 2017 referendum allow Erdoğan to serve as President for up to two terms over a total period of ten years. In the general election held on the same day, the ruling AKP won 295 seats, slightly less than the simple majority of the Grand National Assembly (a one-house parliament with 600 seats for a five-year term), but the ruling coalition including the Nationalist Movement Party (Turkish: Milliyetçi Hareket Partisi, MHP) retained a majority of 344 seats.

Turkey's domestic security situation is recovering. Since it launched military operations in Syria and Iraq in 2015 against the Islamic State (Turkish: DAESH) and militia groups under Kurdistan Workers' Party (Kurdish: Partiya Karkerên Kurdistanê, PKK), which is listed as a terrorist organization internationally, terrorist attacks believed to be by those forces have frequently occurred in Turkey. However, the Erdoğan administration conducted a massive mop-up operation against them and strengthened its crackdown on terrorist organizations by declaring a state of emergency after a failed coup in 2016. As a result of these efforts, no major terrorist attacks have occurred in Turkey since the IS attack in January 2017. The state of emergency was lifted in July 2018.

On the diplomatic front, deterioration of Turkey's

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relations with the US peaked in August 2018, but the situation has since been improving rapidly. The bilateral ties severely worsened due to the following factors: (1) the US supported the Kurdish militia group, which Turkey regards as a terrorist organization, as an armed force opposed to the Islamic State and the Assad administration in the Syrian Civil War; (2) Turkey demanded extradition of Fethullah Gülen, who lives in the US, over his alleged involvement in the coup attempt in July 2016; and (3) Turkey arrested a US pastor in 2016 for his alleged links to the coup attempt. The Trump administration pressed the Erdoğan administration to resolve the third issue before the US mid-term election in November 2018. However, the Erdoğan administration took a hard-line stance and the bilateral feud peaked as the US government decided in August 2018 to double the tariffs on steel and aluminum imports from Turkey.

However, the Turkish lira steeply depreciated after the tariff hike and the third issue was resolved after Turkey softened its attitude and released the US pastor in October 2018. In the same month, Saudi journalist Jamal Ahmad Khashoggi was killed in Turkey and the Turkish government held Saudi Arabia responsible, claiming that it has evidence for its involvement in his death. Since then, the US attitude toward Turkey has softened, with some media reporting that Washington is considering handing over Gülen to Turkey. Behind this development is the view that the US did not want Turkey to step up its accusation of Saudi Arabia, its important ally. Gülen has not been handed over yet.

With regard to first issue, the Islamic State, which the US has been mopping up with the Kurdish military organization, had setbacks after the fall of Rakka in October 2017, and President Trump in December 2018 declared victory and announced withdrawal of troops from Syria. This is expected to lead to the suspension of US support for the Kurdish militia organizations. After these developments, the relations between the US and Turkey have been swiftly improving since the autumn of 2018.

3. Economic base

Turkey boasts the largest GDP in the Middle East (USD 773.4 billion in 2018) and a per capita GDP of USD 9,632, establishing a relatively developed economic base. It has a population of about 80 million, the third largest in the Middle East after Egypt and Iran. Its ratio of working-age population is in upper 60%, which is one of the highest among the major emerging countries. According to the United Nations Population Prospects, the ratio is expected to remain at that level until around 2040. For this reason, the Turkish economy is expected to enjoy a population bonus for some time to come. In addition, because of its geographical advantage, it has a high potential not only for the domestic market but also as a base for export to the EU with which it has a customs union and to neighboring Middle Eastern countries. Among major companies at home, conglomerates such as Koç and Sabancı have a big presence along with former state-owned corporations like Turkish Airlines and Turkish Telecom. Turkey actively takes in foreign direct investment. The world's leading automakers are engaged in production in the country while its consumer electronics, steel and chemical manufacturers enjoy a good reputation in the European market. Furthermore, the tourism industry blessed with rich tourist resources also occupies an important position in the Turkish economy.

The Turkish economy grew 7.4% in real GDP terms in 2017 and 6.2% in the first half (January-June) of 2018, much faster than its potential growth rate (estimated at around 5%), spurred by a spate of stimulus measures taken by the Erdoğan administration. Just in such situation, the Trump administration announced economic sanctions on Turkey in August 2018, sending the lira plunging in value. As domestic interest rates surged following the lira's depreciation, the real GDP growth rate decelerated to 1.6% year-on-year in the July-September quarter of 2018 from 5.3% in the April-June quarter. The real GDP growth recorded ▲3.0% in the October-December quarter of 2018, and the annual growth rate in 2018 resulted in 2.6%. Given that the leading economic index (released by the Central Bank of Turkey) has been negative since October 2018, it is highly likely that the economy will contract through at least the first half of 2019.

Turkey's CPI inflation rate gained steam on an upsurge of import prices caused by a weaker lira that began in 2017. As the currency sharply depreciated in August 2018, the rate zoomed to 25.2% year-on-year in October 2018. However, it has been slowing down since November that year on a rally of the lira and the fall of global energy prices that began in the autumn. The inflation rate declined to 20.4% in January 2019. Its downward trend is expected to continue in 2019 if the exchange rate remains at the current level.

The government announced a New Economic Program (NEP) in September 2018, outlining future economic prospects and fiscal plans. The plan predicted the economic growth rate will slow to 2.3% in 2019 and begin recovering later on to reach a level of 5% in 2021. JCR sees the government's outlook as somewhat optimistic. It expects the growth rate to dip close to 0% in 2019 before recovering moderately to around 4% through 2021.

4. External position

Turkey's current account deficit has been continuing since 2003, widening to 5.6% of GDP in 2017. However, the growth of goods imports began decelerating due to the impact of a weaker lira that began in 2017 and a slowdown of the economy that began in 2018. Goods imports have been sharply falling since August 2018 amid the lira’s steep depreciation and the contraction of domestic demand caused by the surge of domestic interest rates. As a result, the current account deficit turned into a surplus on a single-month basis from August to November 2018, and the deficit for the full year 2018shrunk to 3.6% of GDP. Based on its estimate that the economy will substantially slow in 2019, JCR expects the current account deficit to shrink further to around 1% of GDP in the year, with the improvement on the external balance accelerating rapidly.

With the large current account deficit covered by capital inflows from overseas, external borrowing by domestic financial institutions grew sharply amid the global monetary easing that followed the Lehman shock. However, the U.S. economic sanctions in August 2018 triggered a substantial outflow of nonresident capital from domestic bonds. The rollover ratio of domestic banks' external debt (particularly short-term debt), or the ratio of new borrowings to debt redemption, fell far below 100%. Deposits of domestic residents also flowed out of the country at that time. As a result, the lira plunged to new lows after losing more than 20% against the US dollar on a monthly basis in August 2018. Faced with the situation, the Central Bank of Turkey decided in mid-September to raise its policy interest rate (one week repo rate) by 625 basis points from 17.75% to 24.00%. In late September, the government announced the NEP, downgrading its growth outlook for 2019 and suspending major infrastructure development projects. These somewhat helped to ease market concerns over the management of economic policy by the government and the central bank. Furthermore, the strained relations with the US, which triggered the plunge of the lira, have improved rapidly since October 2018 as stated above. Against the backdrop of these developments, the lira's decline came to a halt from October onward and the currency has since been regaining stability.

On the other hand, Turkey’s external financing needs remained unabated. Such needs of the government and the private sector, as measured in terms of the total amount of the current account deficit, principal and interest payments of external debt, and short-term external debt outstanding at the end of the previous year, amounted to USD 213.2 billion at the end of 2017, twice as much as the official reserve assets managed by governmental authorities. The amount itself declined 3.7% to USD 205.4 billion at the end of 2018 due to the reduction of the current account deficit and reduced demand for new external borrowing. However, as the official reserve assets also fell from USD 107.7 billion to USD 93 billion in the same period, the ratio of external financing needs to the official reserve assets remained high at 2.2 times. Future developments in external financing needs warrant continued attention.

Under these circumstances, there emerged a situation where new external borrowings by some domestic banks have begun to fall short of their external debt repayments. As of September 2018, their rollover ratio stayed below 100%, or 86% for short-term debt and 90% for long-term debt. This was seen attributable to a series of developments, including the downturn of the real sector and the deterioration of relations with the US, which led to a sharp rise in the funding cost for banks in the international financial markets, as well as a setback of demand for foreign currency-denominated loans by domestic banks due to the slowdown of the economy. According to data made available by the central bank, the rollover ratio of external syndicated loans borrowed by banks stayed higher than 100% even after the lira’s sudden fall.

While banks need to cover their external debts with a rollover ratio lower than 100% with their own funds, they have enough foreign currency liquidity to repay such debts for the time being. Thanks to the various measures taken by the central bank, the banking sector’s foreign currency liquidity ratio (the ratio of foreign currency-denominated liquid assets to foreign currency-denominated liabilities due within one year) rose to about 120% as of the end of September 2018. Its foreign currency-denominated liquidity coverage ratio (LCR) has also been maintained at around 180%, well above the central bank's 80% lower limit. The banks therefore seem to be able to repay their external debts in the immediate future with their liquidity funds on hand. Under the macro-prudential regulations by the central bank, the foreign currency net open position of the banking sector has been almost balanced over the entire period through active use of currency hedging. The non-financial corporate sector's short-term foreign currency net open position also stays more or less balanced by hedging. Therefore, their foreign exchange losses resulting from the lira's plunge seem to be rather limited.

However, there is a possibility that a sudden external factor, such as the deterioration of relations with the US, might make Turkish banks and companies harder to keep access to the international financial markets. This may result in a sharp decline of the external debt rollover ratio, letting the private sector fall behind in debt repayment with its own cash. Increased defaults by private companies alone may not directly lead to deterioration of the government's creditworthiness. However, JCR consider that they can affect the creditworthiness of the government through two major channels: (i) the foreign currency supply will become tighter and the reserve assets managed by the government authorities will decline through its foreign-currency supply operations to the market; and (ii) rising domestic interest rates will push up the government's borrowing cost. With regard to the former, the narrowing current account deficit and reduced demand for new external borrowings may serve as factors to ease the tight foreign currency supply. As to the latter, while interest payments by the central government increased 26.0% in 2018 from the previous year, they accounted for only 9.7% of its revenue. Compared to the Philippines (12.6% in 2017), India (27.6%), Indonesia (13.8%) and Brazil (19.3%), which are rated by JCR in BBB range, Turkey' revenue still has some room to absorb increased interest payments. Therefore, the possibility of increased defaults in the private sector immediately impairing the government's creditworthiness may not be high for the present.

5. Financial systems

The Turkish financial system is highly sound thanks to the macro-prudential policy reinforced by banking supervision authorities since the country's financial crisis in 2000-01. Its buffer against shocks is solid. The impacts of the lira's recent depreciation and the rise of domestic interest rates are expected to be somewhat eased by various measures taken by the banking authorities.

Nonperforming loans held by Turkish banks began to increase faster in June 2018 in keeping with the downturn of the domestic economy. The pace of increase further accelerated following the sharp fall of the lira in August 2018 and the subsequent surge of domestic interest rates. The NPL ratio, which had been hovering at around 3% in recent years, rose to 4.0% at the end of December 2018. With the Turkish economy seen to further decelerate, the ratio is expected to keep rising. The banking sector's loan-loss reserve ratio, which stood at around 80% at the end of 2017, fell to about 70% at the end of September 2018 as more loans became nonperforming. The increasing cost of loan-loss reserves will put downward pressure on banks' profitability in the future.

Faced with the situation, the Banking Regulation and Supervision Authority (BRSA) introduced new regulations to facilitate debt restructuring by individual companies immediately after the plunge of the lira in August 2018. In September, the Banks Association of Turkey and BRSA jointly worked out a "Financial Restructuring Framework Agreement" based on the regulations, allowing companies that met certain conditions to restructure their debt within two years. The regulations provide that debt restructuring is possible when agreed by more than two-thirds of all creditors. A further deterioration of the NPL ratio will be somewhat restrained as the framework agreement will prompt a collective debt restructuring.

Meanwhile, the banking sector's capital adequacy ratio slightly improved from 16.9% at the end of 2017 to 17.3% at the end of 2018. Despite the lira's fall and the rise of interest rates, fluctuations of the capital adequacy ratio have remained small due to the temporary measures introduced by the BRSA in August 2018 for the calculation of the ratio. Those measures consist of (i) suspension for inclusion of unrealized gains/losses on available-for-sale securities into other comprehensive income and (ii) fixation of the exchange rate used to calculate the risk assets. The capital adequacy ratio is less likely to be affected by exchange rate fluctuations while the measures remain effective.

6. Fiscal base

On the fiscal front, Turkey's direct tax revenues were sluggish in 2018 amid the progress on economic adjustments necessitated by the lira's steep depreciation and the sharp rise of interest rates while personnel expenses and interest payments rose significantly. As a result, the central government's fiscal deficit (budget cash balance) in 2018 reached 2.4% of GDP, up from 1.7% in 2017. External debt accounted for 37.5% of Turkey's general government debt as of the end of 2017. The general government debt rose from 28.3% of GDP at the end of 2017 to 32.6% at the end of September 2018 mainly because its lira-denominated value inflated due to the currency's depreciation.

The government annually announces a medium-term fiscal plan called Medium Term Program, which summarizes the future economic outlook and fiscal plans. It changed the name of the plan to New Economic Program (NEP) when announcing a plan for 2018 after the presidential election in June 2018. As mentioned above, the plan predicted the real GDP growth rate will decelerate to 2.3% in 2019. It said that while interest payment burdens may increase, the government will work to increase a primary fiscal surplus and cut its budget deficit to slightly below 2% of GDP by restraining expenditures through revenue reforms and suspension of major infrastructure development projects. It added the general government debt-to-GDP ratio will be gradually reduced to below 30% from 2019 onward.

JCR sees the government's fiscal plan outlined in the NEP as somewhat optimistic. Especially, a drastic restraint on expenditures envisaged by the government will be hard to achieve. JCR holds that the annual budget deficit will expand to 3-4% of GDP over the next three years. Yet JCR estimates that while the general government debt-to-GDP ratio may go up, it will still be contained to mid-30% level in the medium term. This is actually lower than those of the countries rated in the BBB range and JCR thinks the government retains some fiscal room even after the lira's latest depreciation.

7. Overall assessment and rating outlook

The growing tension between the U.S. and Turkey over the country's detention of an American pastor sent the Turkish lira crashing in value on August 10, 2018. Accordingly, on August 14, JCR placed the country's issuer and bond ratings under Credit Monitor with Negative direction and was examining the impact of the currency's plunge on its economy and public finance. Following the placement of the Credit Monitor, the lira has been somewhat recovering thanks to the policy rate hike and the improvement of the relationship with the U.S. Turkey's external balance has been improving with its current account balance turning to positive on a monthly basis due to declining imports amid its economic slowdown. In addition, the government debt outstanding stayed lower at 32.6% at the end of September 2018 although it has been affected by the lira's fall and the increase in interest payments. Meanwhile, the country's foreign reserves have been declining while its external financing needs remain high. Its refinancing has been facing downward pressure amid remaining uncertainty over the government's policy and external environment. All these considered, JCR removed the ratings from the Credit Monitor and affirmed them with Negative outlook on November 27, 2018. The rollover of the large amount of short-term external debts especially in the banking sector remains susceptible to market trends. How the situation will unfold needs to be closely watched.

12008 Turkey

Major Economic Indicators

	UNIT	2014	2015	2016	2017	2018
Real GDP growth	%	5.2	6.1	3.2	7.4	2.6
CPI inflation (annual average)	%	8.9	7.7	7.8	11.1	16.3
Central government fiscal balance to GDP	%	-1.0	-0.8	-1.4	-1.7	-2.4
Central government primary balance to GDP	%	1.3	1.3	0.8	0.3	0.0
General government debt outstanding to GDP	%	28.8	27.6	28.3	28.3	32.6
Current account balance to GDP	%	-4.7	-3.7	-3.8	-5.6	-3.6
Trade balance to GDP	%	-6.8	-5.6	-4.7	-6.9	-5.4
Financial account balance to GDP	%	-4.6	-1.3	-2.6	-4.5	0.5
Offical reserve assets	bn USD	127.3	110.5	106.1	107.7	93.0
Import cover	months	5.9	6.0	6.0	5.2	4.7
Foreign exchange rate (annual average)	TRY/USD	2.2	2.7	3.0	3.6	4.8
External debt outstanding to GDP	%	43.4	46.7	47.5	53.4	62.0
Short-term external debt outstanding to official reserve assets	x	1.1	1.0	1.0	1.1	2.1
External financing needs to offical reserve assets	x	1.7	1.8	1.9	2.0	2.2

* Figures for the most recent period could be indicators based on preliminary figures.

(Notes)
1 The following figures are those based on the end of September 2018:
- general government debt outstanding to GDP, external debt outstanding to GDP and short-term external debt outstanding to official reserve assets.
2 Fiscal balance is cash-balance basis.
3 External financing needs = current account deficcit + principal and interest payments of external debt + short-term external debt outstanding at the end of the previous year

Source: Ministry of Treasury and Finance, Central Bank of Turkey, Turkish Statistical Institute and CEIC

Ratings

(millions of yen)

	Rating	Outlook*	Amount	Rate (%)	Issue Date	Maturity Date	Release
Japanese Yen Bonds Series E Series 1 (2017)	BBB-	-	37,000	1.81	2017.12.07	2020.12.07	2018.11.27
Japanese Yen Bonds Series E Series 2 (2017)	BBB-	-	2,000	1.81	2017.12.07	2020.12.07	2018.11.27
Japanese Yen Bonds Series E Series 3 (2017)	BBB-	-	1,000	1.81	2017.12.07	2020.12.07	2018.11.27
Japanese Yen Bonds Series E Series 4 (2017)	BBB-	-	700	1.81	2017.12.07	2020.12.07	2018.11.27
Japanese Yen Bonds Series E Series 5 (2017)	BBB-	-	3,000	1.81	2017.12.07	2020.12.07	2018.11.27
Japanese Yen Bonds Series E Series 6 (2017)	BBB-	-	2,400	1.81	2017.12.07	2020.12.07	2018.11.27
Japanese Yen Bonds Series E Series 7 (2017)	BBB-	-	3,600	1.81	2017.12.07	2020.12.07	2018.11.27
Japanese Yen Bonds Series E Series 8 (2017)	BBB-	-	3,000	1.81	2017.12.07	2020.12.07	2018.11.27
Japanese Yen Bonds Series E Series 9 (2017)	BBB-	-	3,600	1.81	2017.12.07	2020.12.07	2018.11.27
Japanese Yen Bonds Series E Series 10 (2017)	BBB-	-	3,700	1.81	2017.12.07	2020.12.07	2018.11.27
Foreign Currency Long-term Issuer Rating	BBB-	Negative	-	-	-	-	2018.11.27
Local Currency Long-term Issuer Rating	BBB-	Negative	-	-	-	-	2018.11.27

History of Long-term Issuer Rating (Foreign Currency Long-term Issuer Rating or its equivalent)

Date	Rating	Outlook*	Issuer
2004.03.12			Turkey
2005.03.10			Turkey
2007.12.28	BB-	Stable	Turkey
2009.06.04	BB-	Stable	Turkey
2010.02.01	BB	Stable	Turkey
2011.02.21	BB	Stable	Turkey
2012.06.28	BB	Stable	Turkey
2013.05.23	BBB-	Stable	Turkey
2014.07.11	BBB-	Stable	Turkey
2015.08.28	BBB-	Stable	Turkey
2016.10.07	BBB-	Stable	Turkey
2017.11.10	BBB-	Stable	Turkey
2018.08.14	#BBB-	Negative	Turkey
2018.11.27	BBB-	Negative	Turkey

*Outlook for Foreign Currency long-term issuer rating, or direction in case of Credit Monitor

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